



APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

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(f) *Involuntary Conversions*.—If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property*.—The basis of property shall be the cost of such property; except that—

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(9) *Involuntary Conversion*.—If the property was acquired, after February 28, 1913, as the result of a compulsory or in-

voluntary conversion described in section 112 (f), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made.

Sections 112 (f) of the Revenue Act of 1932, c. 209, 47 Stat. 169, and the Revenue Act of 1934, c. 277, 48 Stat. 680, are identical with Section 112 (f) of the Revenue Act of 1936. Section 113 (a) (9) of the Revenue Act of 1934 and 113 (a) (10) of the Revenue Act of 1932 are substantially the same as Section 113 (a) (9) of the Revenue Act of 1936.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 579. *Involuntary conversion of property.*—Section 112 (f) deals with cases in which property is compulsorily or involuntarily converted into similar property, or into money, as a result of fire, shipwreck, theft, condemnation, or similar causes enumerated in the Act. If the property so destroyed, stolen, seized, or condemned is replaced in kind by similar property or property related in service or use, no gain or loss is recognized. If, however, the original property is compulsorily or involuntarily converted into money, gain or loss will be recognized unless the money

is forthwith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended—

(1) In the acquisition of other property similar or related in service or use to the property so converted,

(2) In the acquisition of control of a corporation owning such other property, or

(3) In the establishment of a replacement fund.

If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended. See article 601 for the basis for determining gain or loss from the sale or other disposition of the property so acquired.

ART. 580. *Replacement funds.*—In any case where the taxpayer elects to replace or restore the converted property but it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage. In such a case the taxpayer should make application to the Commissioner on Form 1114 for permission to establish such a replacement fund, and in his application should recite all the facts relating to the transaction and declare that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require in an amount not in excess of double the estimated additional income taxes which would be payable if no replacement fund were established. (See section 1126 of the Revenue Act of 1926.) The esti-

mated additional taxes, for the amount of which the claimant is required to furnish security, should be computed at the rates at which the claimant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant, and the surety or depositary may each have a copy.

ART. 601. *Property acquired by an involuntary conversion.*—In the case of property acquired after February 28, 1913, as the result of an involuntary conversion described in section 112 (f) and article 579, the basis of the property shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which the conversion was made.

Example: A vessel purchased by A in 1923 for \$100,000 is destroyed in 1932, and A receives insurance in the amount of \$200,000. Disregarding, for the purpose of this example, the adjustment for depreciation, if A invests \$150,000 in a new vessel, taxable gain to the extent of \$50,000 would be

recognized. The basis of the new vessel is \$100,000; that is, the cost of the old vessel (\$100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel (\$50,000) plus the amount of gain recognized upon the conversion (\$50,000).

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 112 (f)-1 [as amended by T. D. 4951, 1939-2 Cum. Bull. 110]. *Reinvestment of proceeds of involuntary conversion*.—In order to avail himself of the benefits of section 112 (f) it is not sufficient for the taxpayer to show that subsequent to the receipt of money from a condemnation award he purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased. It is not necessary that the proceeds be earmarked, but the taxpayer must be able to prove that the same were actually reinvested in such other property similar or related in use to the property converted. The benefits of section 112 (f) can not be extended to a taxpayer who does not purchase other property similar or related in service or use, notwithstanding the fact that there was no other such property available for purchase.

If, in a condemnation proceeding, the Government retains out of the award sufficient funds to satisfy liens (other than liens due to special assessments levied against the remaining portion of the plot or parcel of real estate affected for benefits accruing in connection with the condemnation) and mortgages against the property

and itself pays the same, the amount so retained shall not be deducted from the gross award in determining the amount of the net award. An amount expended for replacement of an asset, in excess of the recovery for loss, represents a capital expenditure and is not a deductible loss for income tax purposes.

The provisions of section 112 (f) are applicable to property used for residential or farming purposes.

The proceeds of a use and occupancy insurance contract, which by its terms insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been.

There is no investment in property similar in character and devoted to a similar use if—

(1) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(2) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.

(3) The owner of a requisitioned tug uses the proceeds to buy barges.

It is incumbent upon a taxpayer "forthwith" to apply for and receive permission to establish a replacement fund in every case where it is not possible to replace immediately. If an expenditure in actual replacement would be too late, a request for the establishment of a replacement fund would likewise be too late.

ART. 112 (f)-2. *Replacement funds.*—In any case where the taxpayer elects to re-

place or restore the converted property but it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage. In such a case the taxpayer should make application to the Commissioner on Form 1114 for permission to establish such a replacement fund, and in his application should recite all the facts relating to the transaction and declare that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require in an amount not in excess of double the estimated additional income taxes which would be payable if no replacement fund were established. See section 1126 of the Revenue Act of 1926, as amended (paragraph 31 of the Appendix to these regulations), providing that where a bond is required by law or regulations, in lieu of surety or sureties there may be deposited bonds or notes of the United States. The estimated additional taxes, for the amount of which the applicant is required to furnish security, should be computed at the rates at which the applicant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant, and the surety or depositary may each have a copy.

ART. 113. (a) (9)-1. *Property acquired as a result of an involuntary conversion.*—The provisions of section 113 (a) (9) may be illustrated by the following example:

Example: A vessel purchased by A in 1926 for \$100,000 is destroyed in 1936 and A receives insurance in the amount of \$200,000. Disregarding, for the purpose of this example, the adjustment for depreciation, if A invests \$150,000 in a new vessel, taxable gain to the extent of \$50,000 would be recognized. The basis of the new vessel is \$100,000; that is, the cost of the old vessel (\$100,000) minus the money received by the taxpayer which was not expended in the acquisition of the new vessel (\$50,000) plus the amount of gain recognized upon the conversion (\$50,000). If any amount in excess of the proceeds of the conversion is expended in the acquisition of the new property, such amount may be added to the basis otherwise determined.

Articles 112 (f)-1, 112 (f)-2, and 113 (a) (9)-1 of Treasury Regulations 86, promulgated under the Revenue Act of 1934, are similar to the above-quoted Articles of Treasury Regulations 94.

